9. Compliance

Introduction

9.1 This chapter deals with compliance risk. This is the most significant risk that a regulatory regime for collective investment schemes must deal with.[1] Dealing adequately and in a cost effective way with compliance risk is the central element of the regulatory regime the Review recommends for collective investment schemes. This chapter and chapter 10 make recommendations to address that risk.

The importance of compliance with the law

Widespread view

9.2 Submissions and consultations revealed a widespread view that the focus of the regulation of collective investment schemes should be on compliance with the law and with the scheme's constitution.[2] The Review agrees. It is important that the conditions under which people invest in a scheme are met. Regulation should be directed at minimising compliance risk.

Displacement of responsibility

9.3 The Review was told, particularly by trustee companies, that, under the current regime regulating prescribed interest schemes, some management companies tend to use the trustee as a way of determining whether what they propose to do complies with the law and the terms of the trust deed. Rather than taking responsibility themselves for the legality of an investment proposal, they tend to regard a proposal as acceptable if the trustee approves it. They may also regard a claim for expenses as acceptable if they can get it approved by the trustee. This attitude arises in large part because of the presence of the trustee, which may do little to encourage managers to take responsibility themselves for seeing that the law and the scheme's constitution are adhered to.

Addressing compliance risk

Responsibility for, and focus on, compliance

9.4 There are two important elements in addressing compliance risk. First, it must be very clear who has responsibility for ensuring compliance. This is best done by providing that the scheme operator has full responsibility for all aspects of compliance with the law and the scheme constitution. The scheme operator is best

1. See para 2.8.
2. Submissions from the trustee industry argued that the kind of protection trustees provide, and are most often regarded as providing, to investors is ensuring that the manager complies with the law and with the deed: see, eg, Permanent Trustee Company Limited *Submission* 18 December 1992. The TCA suggested that the focus of a trustee's duty should be to ensure that the operator adheres to the deed, the prospectus and the legislation: TCA *Submission* 10 December 1992.

positioned to ensure that this issue is addressed when the scheme is created and throughout its operation. Secondly, the law must be designed to focus the mind of a scheme operator constantly on that responsibility.

Incentive and responsibility

9.5 Compliance risk will be contained if scheme operators establish and give effect to compliance measures that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme's constitution. The measures the Review envisages would include rules and procedures to be followed at every stage in the management of the scheme which eliminate, as far as reasonably possible, the risk of mistake, neglect or fraud in the conduct of the scheme, and a system of checks and independent auditing to ensure that those rules and procedures are being complied with. The law should underwrite the desirability of operators implementing such measures. Simply requiring operators to have adequate[3] compliance measures is not, however, the most effective way to achieve this. Operators must also be given an incentive to address the issue of compliance risk and must be made to take responsibility for the compliance measures under which their schemes operate. This incentive can be provided by making it a defence to most prosecutions for breaches of the law that the operator was taking all reasonable measures to prevent relevant contraventions.[4] Encouraging scheme operators to take responsibility for compliance measures can also be achieved by requiring them to certify that the compliance measures under which they will operate are adequate.

Focus on compliance can be achieved by licensing operators

9.6 The need to discharge its obligations and to maintain its commercial reputation should, ideally, provide enough encouragement for a scheme operator to adopt the highest standards of compliance with the law and the scheme constitution. However, to ensure this focus is maintained and to promote investor confidence in the collective investments industry, the law should reflect the centrality of compliance. An appropriate way to achieve this is to license operators, with the focus of the licensing process being the adequacy of their compliance measures. The law should specify a number of matters to which the regulator must have regard when considering the compliance measures proposed in a licence application.[5] Even more importantly, a licensing regime should provide a mechanism for making scheme operators take responsibility for the way in which compliance risk is addressed in their schemes. Scheme operators should have to endorse the compliance measures under which they will operate. Also, it should be a ground for an operator's licence to be revoked that there is a reasonable risk that the law or the scheme's constitution will be breached.

3. 'Adequate' means that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme's constitution.
4. See ch 15.
5. The process of licensing is discussed more fully in ch 10.

Form of compliance measures will not be prescribed

9.7 The law should not specify what will constitute adequate compliance measures. Rather, the law should place the responsibility on the scheme operator to develop and implement an appropriate set of compliance measures to address a minimum number of mandatory matters. This allows for flexibility — compliance procedures will be adjusted according to the nature and features of individual schemes. This is vital to an efficient and effective regulatory framework, particularly given the wide range of schemes that fall within the definition of a collective investment scheme.

Honesty and solvency relevant to compliance

9.8 The risk of non-compliance with the law and with a scheme's constitution will be higher if the scheme operator or one of its responsible officers has a history of dishonesty. An operator should not be permitted to conduct a scheme if one of its responsible officers has a recent conviction for serious fraud or has recently been subject to a civil penalty for an act of dishonesty. If the operator itself has been convicted of serious fraud or been subject to a civil penalty for an act of dishonesty, its suitability as a scheme operator must be closely scrutinised. The Review makes various recommendations in the context of licensing operators to exclude such corporations and individuals from the collective investments industry.[6] The risk of non-compliance is also likely to increase if the operator of a scheme, or one of its officers, is severely financially constrained. In principle, an individual who has failed to manage his or her own financial affairs successfully should not be given the opportunity to mismanage other people's money while still an undischarged bankrupt. Again, the best way to enforce such restrictions is through the licensing process. The Review makes recommendations about this in chapter 10.[7]

Non-executive directors to improve compliance

Proposal and submissions

9.9 The Review has considered whether there is a role for non-executive directors in reducing compliance risk in collective investment schemes. DP 53 asked whether there should be a requirement for non-executive directors on the boards of scheme operators.[8] Submissions revealed varied views on the effectiveness of non-executive directors in providing control over management and supervision of executive directors. Those in favour of non-executive directors argued that they have fewer possible conflicts of interest and can help to scrutinise management activities and that they would be a 'desirable check and balance' for a scheme operator.[9] Others considered that non-executive directors cannot exercise

6. See para 10.52-10.54.
7. See para 10.52.
8. Issue 4E. Non-executive directors are neither involved in the day-to-day running of the company nor dependent upon that directorship as their main means of livelihood.
9. eg TCA *Submission* 17 December 1992; BT *Submission* 15 December 1992. Evidence in support of independent directors was provided to the Lavarch Committee: see Lavarch Report 5.5.7-5.5.10.

any substantial control as they may face difficulties in getting access to or fully understanding corporate information and they meet infrequently.[10] Two submissions queried the availability of non-executive directors.[11]

Recommendation

9.10 The Review has concluded that non-executive directors would bring to a scheme operator a degree of detached supervision that could enhance the standard of corporate governance of the operator and the schemes it operates. Non-executive directors of corporations are required to exercise reasonable care and diligence in exercising that supervisory function.[12] They could, therefore, significantly reduce the compliance risk of collective investment schemes. To ensure the appropriate degree of detachment, a non-executive director should be subject to two restrictions: he or she should not be, or have been during the previous three years, an employee or executive officer of the scheme operator or of an associate of the operator[13] or hold any shares in the operator or an associate of the operator. The second restriction is warranted because any shareholding in the operator may give a director an incentive to prefer the interests of the operator over those of the investors in the operator's schemes. This may reduce his or her effectiveness as a means of improving compliance. The Review **recommends** that, to enhance compliance with the law and the scheme constitution, at least half of the board of scheme operators should, at all times, be non-executive directors. Breach of this obligation for more than 14 days, without reasonable excuse, should be an offence.[14] The potential problem of not finding enough people willing to act as non-executive directors is reduced as persons may act as non-executive directors for any number of operators.[15]

Custody of scheme property

Issue

9.11 Who holds the scheme property, and under what arrangements, are key factors in any assessment of the compliance risk of a collective investment scheme. The following paragraphs consider whether there should be restrictions on who can

10. The Review notes that in a recent case it was considered reasonable to expect that directors would inform other directors of relevant information uncovered between directors' meetings: *ASC v Gallagher* (1993) 10 ACSR 43.
11. Arthur Robinson & Hedderwicks *Submission* 10 December 1992; ASCPA & ICAA *Submission* 15 February 1993.
12. *AWA Ltd v Daniels* (1992) 7 ACSR 759; *ASC v Gallagher* (1993) 10 ACSR 43.
13. Being a non-executive director for an associate of an operator should not, however, prevent a person becoming a non-executive director for the operator.
14. The reasonable excuse defence might be available where one or more non-executive directors resign, without an immediate replacement, and the proportion of non-executive directors comprise less than half the operator's board. The defence should be available only where all reasonable measures are being taken to fill the vacancy properly.
15. All directors of scheme operators will owe their primary duty to the scheme investors, not to the operator or its shareholders. The law should provide expressly that they must prefer the interests of investors over those of the company if those interests conflict. It should also provide protection against claims by the operator or its shareholders for directors who acted in investors' interests in a situation where those interests differed from those of the company: see para 10.17.

hold legal title to scheme assets (including whether the operator should be permitted to hold them) and ways of separately identifying them. Under current arrangements, the legal title to the assets of a prescribed interest scheme must be held by a trustee or representative or by the investors themselves.[16] The entity managing the scheme is not permitted to hold the assets of the scheme.[17]

Should the operator be able to hold scheme assets?

9.12 ***Proposal and submissions.*** DP 53 proposed that the scheme operator should be able to hold legal title to a scheme's assets. Alternatively, it could engage another party to hold the assets, although the operator would remain ultimately responsible to investors for the way in which those assets are dealt with.[18] The DP also proposed that a scheme operator that holds scheme assets should have to do so for the use and benefit of the investors in the scheme (that is, on trust for the investors) and keep them separate from its own property.[19] Some submissions supported the proposal.[20] Others argued that, to provide protection against fraud by the operator, scheme assets should always be held by an external party.[21]

> The fact remains that separation of physical control from a scheme's [operator] can only serve to reduce the opportunity for misappropriation or fraud because it creates an additional step which a party intending to commit a fraud must take, involving another party.[22]

At least one submission expressed the view that not requiring a separate custodian in all cases risks a decline in investor confidence by moving out of step with overseas arrangements.[23]

9.13 ***Review's view: scheme operator may hold assets.*** Compliance risk will not be eliminated merely because the title to scheme assets is held by someone other than the operator. A bare custodian, for example, will provide little protection against misuse of scheme property because it will be required to deal with the property as instructed by the scheme operator. Requiring an external custodian in all instances would also be unnecessarily rigid. It would impose costs that may well outweigh the benefits in terms of improved compliance. The Review does not consider this necessary or appropriate. Instead, who holds the assets and the obligations, if any, that they have under the arrangement between them and the

16. This is not prescribed by law. In forming its opinion whether a deed complies with Pt 7.12 Div 5 and the regulations, however, 'the ASC is of the view that it must consider whether . . . (c) the deed effectively provides that all the property to which the scheme relates is vested either in the interest holders on their own account or in the trustee on their behalf throughout the life of the scheme': ASC Policy Statement 23.
17. Unless an exemption is granted from the requirement to have a separate trustee or representative, eg, trustee common funds.
18. Proposal 4.1.
19. Proposal 4.7.
20. eg St George Funds Manager Limited *Submission* 18 December 1992; Credit Union Services Corporation (Australia) Limited *Submission* 27 November 1992; FPAA *Submission* 7 December 1992; MLC Investments Limited *Submission* 17 December 1992.
21. eg Permanent Trustee Company Limited *Submission* 12 November 1992.
22. County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
23. eg Permanent Trustee Company Limited *Submission* 12 November 1992.

scheme operator should be considered as an important factor in determining the adequacy of the scheme operator's compliance measures. Whether compliance measures that involve the operator having custody of scheme assets are adequate will depend on the totality of the compliance measures. The Review is also satisfied that not requiring by statute a separate custodian will not have an adverse impact on Australia's standing in the international financial community.[24] A scheme operator that is permitted to hold scheme assets itself must do so subject to two requirements: it must hold the assets on trust and separately from its own assets.[25]

Scheme operator will hold property on trust for investors

9.14 A scheme operator that holds scheme property must do so on trust for investors. That is, the investors should retain the beneficial ownership of the assets. Where an operator engages a custodian to hold the legal title to scheme assets, the operator should hold on trust for the investors the equitable interest arising under that arrangement. The Review considers that, because of the nature of the activity undertaken, this trust relationship should exist in all collective investment schemes, even those based on contract.[26] This may result in investors in some schemes having a wider range of remedies available than they would otherwise have. The Review **recommends** that the Corporations Law should be amended to provide that, if the operator of a collective investment scheme holds property of the scheme, it will do so on trust for the scheme investors. Schemes in which investors hold the scheme property will not be affected.

Identification of scheme assets held by the operator

9.15 Operators that hold scheme assets must hold them separately from their own assets. Likewise, if an operator holds assets belonging to more than one scheme, they should be separately identified as assets of particular schemes. This will ensure that scheme assets are easily identifiable if a liquidator is appointed to the operator. Currently

> [t]here can be major difficulties for a liquidator in distinguishing an insolvent company's own assets from assets held in trust. Many insolvency lawyers will attest that this is a perennial problem. In the case of a [manager] administering more than one scheme, then absent a custodian, the further difficulty in distinguishing assets owned by different schemes could arise.[27]

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24. If an operator wishes to market a scheme directly to foreign investors and judges that the scheme will not be acceptable unless a separate custodian holds the legal title, it is free to engage a custodian. It is far more likely, however, that, if an Australian operator wanted to tap into the savings of foreigners, it would establish a scheme overseas, in accordance with the rules of the host country, with which overseas investors are familiar, and then invest the funds in Australia.
25. See para 9.14, 9.15. If the title to the assets of a scheme is vested in the investors, the question whether the operator or another person appointed by the operator should hold the assets will not arise.
26. The concept of applying trust law principles to contracts is not new. Under the *Life Insurance Act 1945* (Cth) s 38(8), directors of life insurance companies are deemed to be under the same liability in respect of contraventions of the provisions of the section (which deals with the company's statutory funds into which premium income, including that from investment bonds (ie investment contracts), is paid) as if they had been trustees under a trust.
27. Minter Ellison Morris Fletcher *Submission* 19 November 1992.

It was suggested in submissions that, without the additional requirement of an external custodian, scheme assets could not be kept bankruptcy remote. The Review does not agree. The important element in keeping scheme assets remote from the bankruptcy of a scheme operator is the ability to identify them clearly as assets of a collective investment scheme. This identification could be achieved without the assets being held by a separate party — by having a proper ledger system and by identifying the scheme[28] on all relevant documents evidencing title and on all accounts holding cash of the scheme. It would then be clear to a liquidator appointed to a scheme operator, that the operator is not the beneficial owner of the assets. The Review therefore **recommends** that, if a scheme operator holds scheme assets, it must identify them in such a way that they are clearly property of a particular collective investment scheme. Where the title to property is registered on a public register, the relevant State and Territory laws should be altered to allow the register to reflect ownership by a particular scheme. It will be necessary to ensure that identifying property in this way does not affect a purchaser's ability to take good title. Where there is no registration for particular kinds of property, the scheme operator's records will have to reflect the ownership of the property. To assist in keeping scheme assets separate and identified, the Review also **recommends** that application forms for interests in a collective investment scheme should direct that cheques be drawn in favour of the scheme operator on account of the particular scheme.[29]

Operator may use external custodian

9.16 A scheme operator should be able to appoint an external custodian if it wishes. It may do so for commercial reasons[30] or as part of its stated compliance measures. The arrangements under which any external entity is engaged to hold the legal title to scheme assets, including whether that entity should be required to identify the assets separately, will be an integral part of an operator's compliance measures.[31] As such it will be considered by the regulator in the licensing process.[32] Scheme operators may be able to reduce costs by using an external custodian if the external custodian does not have to identify assets separately.[33] The Review does not consider there is a need to restrict the entities that can be used as external custodians. Also, whether an external custodian will hold the assets for the operator or the investors will be determined by the terms of the arrangement between the operator and the external custodian. There is no need to prescribe this.

28. By name and registration number: see para 4.9.
29. Corporations Regulations reg 7.12.15(6)(bb) prescribes a covenant that the management company will, in all prospectuses and other representations relating to the prescribed interests, direct that all cheques and other payment orders in respect of applications for prescribed interests be drawn in favour of the trustee or representative on account of the particular prescribed interest concerned.
30. It may consider, for example, that the scheme will be more attractive to investors if an entity other than the operator has custody of the assets. It may also find it too much of a burden or inconvenience to hold the assets itself.
31. Currently, a custodian trustee holds legal title to scheme assets in its name. The assets are not separately identified as scheme assets except in the internal records of the custodian trustee.
32. See para 10.45 for discussion of ASC's consideration of custody arrangements in the licensing context.
33. See para 9.15 for requirement to identify scheme assets. The ASC will be able to require an external custodian to identify assets separately by imposing a condition to that effect on an operator's licence: see para 10.46.

Liability of the parties — scheme operator primarily liable

9.17 DP 53 proposed that a person operating a scheme should not be able to assign responsibility. However, one submission suggested that an operator who engaged an independent custodian should be able to assign to the custodian the risk involved in holding assets of a collective investment scheme.

> Assigning the risk to a custodian would ensure that proper contractual arrangements are entered into between the [operator] and the custodian with clear definition of responsibilities of the respective parties. . . . [W]ithout a provision to contractually assign risks to custodians, there is a barrier to entry into the industry for smaller fund managers . . . Investors' interests are best served by promoting competition amongst fund managers and, for this purpose, any proposal which limits entry by creating barriers to entry should be avoided.[34]

The Review affirms its view in DP 53. The scheme operator should always be liable. It should be no defence to a claim arising out of a contravention of the law or the scheme's constitution in relation to a dealing with scheme property that the operator had engaged a custodian to hold the property. That alone should not be enough. Managing other people's money is a responsibility not to be taken lightly and scheme operators must carry the responsibilities associated with this activity. In some cases, under the Review's recommendations, it will be a defence that the operator was taking reasonable compliance measures.[35] These may involve a custodian but the fact that a custodian has been used will not determine the matter. The Review's recommendations do not deal with claims in negligence, that is, claims not based on a contravention of the statute. How these claims are determined against the operator or the custodian is best left to the general law.

Role of person engaged by scheme operator to assist with compliance

9.18 A scheme operator may engage a person with the appropriate capacity and experience to undertake all or some compliance measures.[36] Many operators may continue to engage the services of a trustee company. The role of the trustee company in each case will be determined by agreement between the scheme operator and the trustee company.[37] What its relationship with the investors will be, in particular whether it will have a relationship of trustee and beneficiary, will also be determined by that agreement and the general law. This will provide schemes with a degree of flexibility they do not have now. The scheme operator will always retain primary liability regardless of the compliance measures. If a trustee company or other person supplying compliance services breaches its contract with the operator and that breach causes loss to investors, the operator will remain liable to investors. It may, however, be able to seek indemnity from the

34. County NatWest Australia Investment Management Limited *Submission* 18 December 1992.
35. See para 10.40, 15.4, 15.5.
36. Whether any custodian engaged to hold the legal title to scheme assets is also engaged to perform a compliance role will be a decision for the parties.
37. One scheme operator may wish a trustee company to perform a large part of its compliance measures; another may be capable of doing most compliance tasks itself and merely have the trustee company hold the legal title to the scheme assets.

trustee company or other person under the contract between it and that person.[38] In some circumstances, for example, if the trustee company or person engaged was negligent or fraudulent, that company or person, as well as the scheme operator, may be directly liable to investors at common law. At present, by contrast, it may be unclear whether the trustee or the manager is liable for a particular loss and allocating liability for loss is time consuming and expensive.

Other matters relevant to compliance

Appropriate sanction mechanisms

9.19 An important aspect of a regulatory regime that is directed first and foremost at achieving a high degree of compliance is an appropriate sanctions regime. Breaches of the obligations with which a scheme operator must comply must be dealt with promptly and in an appropriate way. The Review has taken care to recommend a sanctions regime that will provide incentives to comply and that will be effective.[39]

Licensing by ASC and monitoring by ASC and auditors

9.20 The focus on compliance is to be achieved primarily by requiring operators to be licensed by the ASC and requiring the ASC to consider the adequacy of an operator's compliance measures in assessing whether a licence should be granted. The ASC will also have continuing surveillance powers so as to monitor scheme operators and, particularly, the degree to which the compliance measures specified as conditions of their licences are observed. Auditors too will play a role in supervising and monitoring scheme operators.[40]

38. A scheme operator may be able to take action against a trustee company or other person pursuant to the agreement, whether or not any claim was made by investors against the scheme operator.
39. The details of this regime are discussed in ch 15.
40. Details of the regulatory and monitoring roles of the ASC and auditors respectively are discussed in ch 14 and ch 6.